

November 8, 2000

Manager, Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: Docket No. 2000-57

Re: Proposed Conversion Regulations

Dear Manager:

The purpose of this letter is to comment on certain portions of the proposed conversion regulations issued for comment by the Office of Thrift Supervision ("OTS"), specifically 12 CFR Parts 563b and 575, Mutual Savings Association, Mutual Holding Company Reorganizations and Conversion from Mutual to Stock Form. In general, we believe portions of the proposed conversion regulations are responsive to certain aspects of the current OTS conversion regulations. However, we have concerns with the "needs" and "market return on equity" criteria pertaining to the business plans which must receive regulatory non-objection before an OTS-regulated mutual thrift can be authorized to file a conversion application. We have analyzed the proposed conversion regulations (see attached presentation), and we believe that there are several unintended consequences triggered by the needs and market return on equity ("ROE") tests.

RP Financial, LC.

RP Financial, LC. ("RP Financial") is a financial consulting firm serving the financial services industry nationwide. RP Financial specializes in three primary areas: strategic planning for thrifts, banks and other financial intermediaries; corporate valuation for a variety of purposes, including thrift conversion transactions; and merger advisory services.

In providing strategic planning assistance to financial institutions for the last 20 years, as well as actively promoting the mutual holding company structure, we believe these two tests impose criteria which (1) cannot be met without raising safety and soundness issues and (2) poses considerable devaluation risk for existing OTS-regulated mutual holding companies.

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Needs and ROE Tests Defined

We agree with the OTS that institutions intending to conduct a stock offering should prepare a prudent business plan that specifically addresses the use of offering proceeds and strategies for increasing ROE over time. Such stock offerings include a standard conversion offering, a minority stock offering concurrent with a mutual holding company ("MHC") reorganization or a second step offering by a thrift in MHC form. In addition, the investment community also wants converting thrifts to have prudent business plans with the same objectives.

The proposed conversion regulations indicate that conversion business plans must address a reasonable need (the "needs test") and pro forma return on equity (the "ROE test"), which are applicable to standard conversions, MHC offerings and second step conversions. Both the needs and ROE tests are referenced in Section 563b.105 of the proposed conversion regulations and the ROE test is more specifically addressed in the preamble to the proposed conversion regulations in Section II.A. These two tests are summarized below.

Needs Test

1. The converting thrift must demonstrate a reasonable need for new capital to support projected operations and activities; and
2. The converting thrift must show that opportunities are reasonably available in proposed market areas to achieve planned deployment of conversion proceeds.

ROE Test

1. The business plan must demonstrate that the converting thrift will achieve a reasonable ROE commensurate with investment risk, investor expectations and industry norms. Further, at a minimum, the projected ROE should exceed, by a margin reflecting relative investment risk, the institution's rates on long-term certificates of deposit ("CDs"); and
2. Such returns must not consider capital management strategies, such as stock repurchases or returns of capital, even though the investment community does consider such capital strategies in making investment decisions.

OTS-Regulated Thrift Industry Overview

The proportion of OTS-regulated mutual thrifts has steadily declined over the last two decades, in part attributable to mutual thrifts seeking the advantages provided by the stock charter following conversion. OTS-regulated stock thrifts, both publicly and privately held, have consistently leveraged their excess equity for asset growth and diversification; accordingly, stock thrifts are typically more leveraged and generate higher ROE ratios than their mutual counterparts to enhance shareholder value. Today, mutual thrifts represent less than 40% of all OTS-regulated thrifts

and their assets represent roughly 7%, as the mutual thrifts are generally smaller in size. The approximately 475 remaining OTS-regulated mutual thrifts today fall into three asset size classes: 56% with assets under \$100 million ("small mutuals"); 42% with assets between \$100 million and \$1 billion ("medium mutuals") and the remaining 2% with assets over \$1 billion ("large mutuals"). The small mutuals are more highly capitalized, less profitable and have slower growth rates than the medium mutuals and the large mutuals.

The Conversion Market Has Been Functioning Properly

Conversion activity over the last decade has reflected a combination of external factors including, but not limited to, general market conditions, thrifts' need for capital and use of proceeds and the investment community's appetite for investment in thrift conversion offerings. During the early to mid 1990s the conversion activity was relatively heavy as (1) a number of OTS-regulated institutions sought to increase capital in the post-FIRREA environment and (2) the investment community was attracted to such offerings due to the relative investment merits. As the bull market advanced through the mid 1990s, conversion activity slowed as the resulting pro forma equity and ROE levels were less attractive to both institutions and the investment community. Over the latter part of the decade, bearish market conditions led to the period's lowest conversion volume for OTS-regulated thrifts, and many investors shunned such offerings. The mutual thrift industry and the investment community thus appears to have been responsive to need and ROE in the absence of a regulatory framework establishing specific tests. There does not appear to be a reason to codify these tests when the free market appears to have been functioning properly.

Specific Concerns With Needs and ROE Tests

Our concerns with regard to these two tests fall into five general areas, as discussed more fully below.

1. The proposed conversion regulations are a departure from past policy.

The proposed conversion regulations establish business planning criteria which are more difficult to achieve than for past conversions. Thus, mutual thrifts who have been evaluating conversion as part of their business plan under current regulations may now find the ability to convert constrained or effectively blocked, and this seems unfair.

In working with mutual institutions in their strategic planning processes, we frequently find that the decision to convert to stock form or reorganize as an MHC with a concurrent minority stock offering is one of the most significant decisions a Board of Directors will make in the thrift's history. The conversion decision is typically reached after years of evaluating the pros and cons as well as the pro forma impact of the structure.

Based on our experience, the decision to convert to stock form is typically based on achieving the following objectives:

1. Formation of a stock charter to facilitate future expansion and diversification, and thereby keep pace with a rapidly changing financial services industry in which competition is very intense;
2. Increase capital to facilitate future expansion and diversification;
3. Enhance the potential to be a successful buyer by introducing the ability to use stock as merger consideration, rather than simply using cash (the primary form of consideration used by mutual thrifts), to acquire banks, thrifts and other financial companies;
4. Develop competitive, stock-based management compensation plans to attract and retain qualified and innovative personnel, particularly in a market place where talented people seek stock based performance incentives; and
5. Increase customer and community loyalty and referrals as such groups become shareholders, which is a critical factor in rural and smaller urban markets as these thrifts frequently compete with locally-owned banks.

While the business plan typically addresses the nature of expansion and diversification, frequently the specifics of certain strategies cannot be quantified. For example, if a converting thrift intends to acquire other financial institutions, unless the acquisition occurs concurrently with conversion, it is difficult to forecast what acquisitions will be completed, the timing of such and the resulting pro forma impact. In fact, any projections of hypothetical acquisitions would be speculative at best. However, the stock charter and the stock form of consideration positions the thrift to be an active participant in acquisitions of others.

2. The proposed conversion regulations establish criteria which cannot be met by the majority of remaining mutual thrifts.

The proposed conversion regulations impose an ROE test based on a risk premium to the mutual thrift's long-term CD rate – the long-term CD rates for many institutions currently fall in the range of 6.25% to 7.00%. Thus, for a mutual thrift with nominal risk (and thus no risk premium), the pro forma target ROE would approximate 6.25% to 7.00%. In contrast, institutions with a typical risk profile for a mutual thrift would be higher, perhaps in the range of 8-10% or higher.

A retroactive application of the ROE test to the OTS-regulated thrifts that converted during the last decade indicates that less than 15% of the approximately 587 conversions would have met this criteria in the first year following conversion and only 20% would have complied three years following conversion, *even with the benefit of stock repurchases and special dividends*. Specifically, the annual median pro forma ROE at closing for OTS-regulated thrift conversions since 1992 ranged from 3.7% to 7.1%, with the highest median ROE occurring in 1992 at a time when pre-conversion equity ratios were lower and market conditions were more bearish than later in the decade. Second step conversions by OTS-regulated thrifts in MHC form

over the last decade indicate similar low compliance with such an ROE test. Accordingly, despite the market's willingness to purchase the stock issued in conversion by the converting thrifts with their low pro forma ROE ratios, such conversions may not have received regulatory approval to complete their conversions.

It takes time to implement a post-conversion business plan and prudently deploy the proceeds. Typically, a converted thrift initially invests the offering proceeds in high quality short-term securities, and then gradually uses the proceeds in a prudent manner to originate additional loans and leverage the new equity through expansion strategies such as cross-selling, de novo branching, wholesale leveraging and acquisition. Growth through cross-selling and de novo branching can be expected to be slow initially and may even adversely impact short-term profitability due to start-up costs. For example, it is typical for a de novo branch to operate at a loss for 3 to 5 years before reaching a size which can be profitable. Thus, the ROE test may discourage certain cross-selling and de novo branching strategies for converting thrifts, notwithstanding the long-term benefit to earnings. Wholesale leveraging may provide rapid balance sheet expansion provided market conditions result in adequate spreads with reasonable interest rate risk. Due to interest rate risk considerations, however, wholesale leveraging typically increases gradually over time to spread the risk over several interest rate cycles or yield curves.

Similarly, acquisition strategies typically take at least 1 to 2 years following conversion to complete, as time is required (1) for the stock to gain market seasoning, (2) to successfully seek out acquisition opportunities and (3) to complete a specific acquisition once the agreement has been signed. Frequently mergers generate only a marginal earnings benefit to the buyer in the first year and the earnings contribution gradually increases thereafter. Thus, significant earnings contribution from a successful implementation of an acquisition strategy may not begin to be realized until the third or fourth year following conversion.

Thus, several years may be required before a converted thrift can begin to generate an ROE approaching market levels for seasoned thrift institutions. Industry experience indicates that, even after 3-5 years with the benefit of capital management strategies, the ROE of converted thrifts may still lag market levels for seasoned stock thrifts. This suggests the proposed ROE test cannot realistically be met in today's market conditions without significantly compromising the typical mutual thrifts risk profile.

3. The proposed conversion regulations appear to be negatively biased towards small mutual thrifts.

As noted above, the large and medium mutuals have current financial characteristics making it more feasible for them to convert than for smaller thrifts given the needs and ROE tests. Based on current market conditions, small mutuals on average would have a significantly lower pro forma ROE than the large and medium mutuals, thus posing a greater hurdle for small mutuals to gain approval of their conversion business plans. By limiting the ability for small thrifts to convert, the

medium and large thrifts are provided the distinct advantage of pursuing the various opportunities provided by the stock charter, whereas the small mutuals with restricted charter options may be hampered in their ability to remain competitive and viable. Further, we believe the attractiveness of the MHC charter is diminished, particularly for small mutuals (see below), even with certain structural improvements addressed in the proposed conversion regulations and the Interim Final Rule (addressing the dividend waiver issue and stock repurchases by the mid-tier holding company).

4. Stock price devaluation risk for existing OTS-regulated mutual holding companies.

We believe the need and ROE tests pose considerable market value risk to the public common shareholders of thrifts in MHC form, and may significantly impair the ability to complete a second step conversion in most stock market environments, even if an MHC's Board and management were to believe such a transaction may be appropriate and the investment community was be receptive to such an offering. One of the key considerations in current MHCs' reorganization was the ability to complete a second step conversion in the future at a point that the Board of Directors and management determined to be appropriate. If the ability to complete a second step conversion is impaired, we perceive there may considerable devaluation risk of the publicly-traded shares.

As a firm actively involved with MHCs, we believe that the public market pricing for MHC shares is based on the anticipated pro forma impact of completing a second step conversion, with the offering proceeds approximating the value implied by the prevailing stock price. Further, such market pricing anticipates the appraised value determined by an independent appraiser. The appraisal process for the initial offerings by thrifts reorganizing in MHC form is typically based on the pricing of existing publicly-traded MHCs assuming the completion of a second step conversion at their prevailing stock prices – not on the pricing of full stock thrifts.

The proposed conversion regulations change the fundamentals of second step conversions for OTS-regulated MHCs, if the current market pricing would result in pro forma equity levels which cause the needs and ROE tests to not be met. This fundamental change could adversely impact the ability to complete a second step conversion, as these two regulatory criteria were not anticipated when the thrift completed the initial reorganization or when shareholders purchased the stock.

Based on our conversations with members of the investment community familiar with the MHC structure, we believe there exists a considerable market risk to the stocks of OTS-regulated thrifts in MHC form if the ability to complete a second step conversion becomes curtailed due to the needs and ROE tests. Under such circumstances, the market would logically respond by devaluing the shares to the level whereby the second step conversion could be completed. The potential market loss estimates are considerable. Further, if the market value for MHCs declines, then the value for new MHC offerings should decline as well.

5. Diminished attractiveness of MHC charter form.

If a mutual thrift reorganizes in MHC form and conducts a minority stock offering and then subsequently seeks to complete a second step conversion, the ability to complete such a second step transaction may be impaired due to the needs and ROE tests. We believe the risk of being "land-locked" in the MHC form of organization limits the attractiveness of the MHC structure, and thus diminishes the value of minority stock offerings, as resulting investor uncertainty regarding the exit strategy would increase required investment returns. The reduced market value of thrifts in MHC form may also reduce the potential liquidity of the stock, particularly for small thrifts, further limiting the ability to sell the shares in the aftermarket.

OTS ROE Test Exceeds Market ROE Expectations for Initial Public Offerings

As noted previously, the market had a healthy appetite for conversions during the past decade, even when pro forma ROE levels fell short of market levels for seasoned stock thrifts. We examined initial public offerings ("IPOs") in other transactions and industries to determine the investment community's expectations for pro forma ROE. In this regard, we examined a de novo federal savings bank, a demutualizing property and casualty insurance company and an Internet company.

De Novo Federal Savings Bank – Nittany Financial raised \$5 million in an IPO in 1998 and then conducted secondary offerings in 1999 and 2000. The IPO prospectus cited the following risk factors, among others, in being a shareholder: (a) potential loss of total investment; (b) may not be profitable for several years, if ever; and (c) arbitrary pricing of stock (i.e., no fair pricing analysis). Nittany reported two years of operating losses before reporting a small positive ROE this year.

Old Guard Group – Old Guard completed its demutualization offering based on an appraised value in 1997. The IPO prospectus cited the following risk factors, among others: (a) possible fluctuations in operating results; and (b) possible inadequate/adverse impact of potential acquisitions. During the last three years Old Guard's ROE has been marginally positive or negative, well below the industry average for publicly-traded property and casualty insurers.

Amazon.com – Amazon.com completed a \$54 million IPO in 1997 and secondary offerings of \$225 million and \$743 million in 1998 and 1999, respectively. The risk factors cited in the IPO prospectus, among others, included: (a) limited operating history and accumulated deficit; (b) anticipated substantial operating losses in the foreseeable future; and (c) unpredictability of future revenues. Amazon.com recently reported a large capital deficit due to huge operating losses and yet the market capitalization of the stock recently exceeded \$10.7 billion.

Based on these examples and our own market experience the investment community does not appear to require a market level ROE immediately or within the first several years following IPOs.

Summary

In summary, we believe there are a number of unintended consequences of the needs and ROE tests set forth in the proposed conversion regulations including a negative bias towards small mutual thrifts, a devaluation risk for current MHCs, a "land lock" risk for current and new MHCs and an implicit moratorium on thrift stock conversions. These unintended consequences may encourage shrinkage in the number of OTS-regulated mutual thrifts through mutual-to-mutual mergers and charter flips to state savings bank charters, so that these institutions can expand and/or diversify or can gain the opportunities provided by the stock charter. With restricted ability to raise capital, the mutual federal savings bank charter may also be perceived as a less attractive charter for credit unions.

We do not see a need to codify the needs and ROE tests for conversion business plans as the industry and the investment community have responded when pro forma equity levels appeared to reach excessive levels with a reduction in conversion activity. We do not believe the OTS should seek to regulate such aspects of an institution's business plan -- rather, this should be left to the Board and management who are not only intimately familiar with the various internal and external factors impacting the thrift's financial performance and business plan, but are also charged with the responsibility of operating the thrift in a safe and sound manner as well as enhancing the value to shareholders, while also being responsive to customers financial services needs in an increasingly competitive environment.

We ask that the OTS carefully evaluate the ramifications of the needs and ROE tests contained within the proposed conversion regulations.

Sincerely,

A handwritten signature in black ink, appearing to read "Ronald S. Riggins". The signature is fluid and cursive, with the first name "Ronald" being more prominent.

Ronald S. Riggins
Managing Director

Enclosure